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No. 89-280

In the Supreme Court of the United States

OCTOBER TERM, 1989

ESTATE OF DANIEL LEAVITT, DECEASED, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the shareholders of a Subchapter S corporation increased their basis in the corporation (and therefore their ability to offset corporate losses against their income from other sources under 26 U.S.C. 1374(c)(2) (1976)) merely by guaranteeing the corporation's debt to a bank.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-20) is reported at 875 F.2d 420. The opinion of the Tax Court (Pet. App. 21-71) is reported at 90 T.C. 206.

JURISDICTION

The judgment of the court of appeals was entered on May 19, 1989. The petition for a writ of certiorari was filed on August 17, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1979, Daniel Leavitt[1] spent $10,000 to purchase shares of stock in VAFLA Corporation, a Virginia cor-

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[1] The petitioners in this case are the Estate of Daniel Leavitt and the Estate of Evelyn M. Leavitt, which is a party to this proceeding solely because Evelyn Leavitt filed a joint income tax return for 1979 with Daniel Leavitt.

poration formed earlier that year to acquire and operate an amusement park near Tampa, Florida. After its first few months of operation, VAFLA's liabilities exceeded its assets, and it was unable to meet its cash flow requirements. Virtually all of the corporation's assets were already encumbered by a purchase-money mortgage and could not be used as collateral. In August 1979, Leavitt and six other shareholders signed guarantee agreements whereby each agreed to be jointly and severally liable for all of VAFLA's indebtedness to the Bank of Virginia. On September 12, 1979, VAFLA borrowed $300,000 from the Bank of Virginia, giving its note in return. The bank would not have made the loan without receiving the shareholders' personal guarantees. Pet. App. 4-5, 24-25.

The bank loan was reflected on VAFLA's financial statements and tax returns as a loan from the shareholders who had guaranteed the loan. VAFLA made all of the loan repayments to the bank, however, and the shareholders were never asked to make good on their guarantees. Moreover, neither the corporation nor any of the shareholders who had acted as guarantors treated the corporate payments on the loan as constructive income to the shareholders. Pet. App. 5.[2]

VAFLA elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code, Sections 1371 *et seq.*[3] Under these provisions, the income of an electing small business corporation is not subject to the corporate income tax, but rather is taxed on a pro rata basis as income to

[2] If the corporation paid a debt that was personally owed by a shareholder, that payment would be income to the shareholder as a constructive dividend from the corporation.

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C. (1976)) (the Code or I.R.C.), as in effect during 1979, the year in issue.

the shareholders. See I.R.C. §§ 1372, 1373. Any net operating loss incurred by a Subchapter S corporation is similarly passed through to its shareholders, each of whom is entitled to deduct on his individual return his proportionate share of the loss (§ 1374(a))—subject to a maximum that reflects the shareholder's investment in the corporation. The shareholder's deduction for a net operating loss incurred by a Subchapter S corporation is limited to the sum of (A) the shareholder's adjusted basis in the corporation's stock and (B) the adjusted basis of any indebtedness of the corporation to the shareholder (§ 1374(c)(2)).

In its first fiscal year, ended September 30, 1979, VAFLA incurred a net operating loss in the amount of $265,566 (Pet. App. 4 n.4). On their joint income tax return for 1979, Daniel and Evelyn Leavitt claimed a loss of $13,808, based upon the Leavitts' pro rata share of the corporation's loss. On audit, the Commissioner invoked Section 1374(c)(2) to limit the deduction to $10,000—the amount of cash Leavitt had invested in the corporation, and he accordingly asserted a deficiency in the Leavitts' income tax for 1979. Pet. App. 26.

2. Petitioners sought redetermination of the asserted deficiency in the Tax Court, which sustained the deficiency in a reviewed decision by a 19-1 vote (Pet. App. 21-71). The majority rejected petitioners' contention that Leavitt's guarantee of VAFLA's debt to the Bank of Virginia operated to increase the amount of the allowable loss deduction "cap" imposed by Section 1374(c)(2). The court explained that Leavitt's basis in his Subchapter S corporation stock was "cost," as established by Section 1012 of the Code. His ability to deduct losses under Section 1374(c)(2)(A) therefore was limited to his actual out-of-pocket investment in the corporation. Because the guarantees in the instant case had not involved "an economic outlay or a realization of income" (Pet. App. 30), the court concluded that the

guarantees did not serve to increase the shareholders' bases in the corporation. *Id.* at 30-32.

The Tax Court specifically rejected petitioners' contention that the bank loan transaction should be recast as a loan from the bank to the shareholders, followed by contribution of the loan proceeds by the shareholders to the corporation (a contribution that would have increased their equity in the corporation) (Pet. App. 33-41). The court noted that the bank in fact had lent the money to the corporation, that it had earmarked the loan proceeds for use in the corporation's business, and that the shareholders were not free to dispose of the proceeds as they wished. The court further noted that the corporation's payments on the loan had not been treated as constructive income to the seven shareholders on either the corporate or individual returns for the years in issue. Accordingly, the court concluded that the substance of the bank loan transaction was fully consistent with its form as a loan to the corporation rather than to the shareholders. *Id.* at 33.

Because the shareholders had made no economic outlay at all in connection with the loan from the bank to the corporation, the court found it unnecessary to examine the factors usually applied to determine whether a debt transaction should be regarded as a contribution to equity. See Pet. App. 33-36 & n.8. Finally, the Tax Court expressed its disagreement with the Eleventh Circuit's view in *Selfe* v. *United States*, 778 F.2d 769 (1985), that a shareholder's guarantee of corporate debt can increase his basis if the lender was looking primarily to the shareholder for repayment (Pet. App. 37-41). The Tax Court explained that this approach would allow the shareholders of Subchapter S corporations to avoid the specific limitation enacted by Congress that restricts the loss deductions of a Subchapter S shareholder "to the amount he has actually invested in the corporation" (*id.* at 38).

Three judges concurred only in the result. Judge Williams filed a separate opinion, stating that he agreed with the result reached by the majority but expressing the view that the majority had "unnecessarily reject[ed]" the reasoning of *Selfe* (Pet. App. 42-43). He explained that *Selfe* had involved a corporation wholly owned by one shareholder, where "the form of the transaction had no tax significance" (*id.* at 42), and he maintained that "the *Selfe* rationale can be correctly applied" in certain circumstances, "limited to cases involving the sole shareholder" (*id.* at 43).

Judge Fay dissented (Pet. App. 43-71). He argued that the rationale of *Selfe*—namely, "that traditional debt-equity principles are applicable in determining whether a shareholder-guaranteed subchapter-S corporate debt should be recharacterized as a capital contribution" (*id.* at 49)—is correct and is fully applicable to this case. He further concluded that these principles would justify treating the guarantee here as equity—*i.e.*, that the corporate bank debt should be viewed as a loan to the shareholders, followed by their contribution of the loan proceeds to the corporation—because the bank looked to the shareholders for repayment (*id.* at 61-66). Judge Fay proceeded to find that this conclusion required recharacterizing the corporation's loan repayments to the bank as cash distributions to the shareholders followed by payments by the shareholders of principal and interest to the bank (*id.* at 67).

3. The court of appeals affirmed (Pet. App. 1-20). It agreed with the Tax Court's conclusion that the shareholder guarantees gave rise to no increase in basis under Section 1374(c)(2), reasoning that petitioners "have experienced no * * * call as guarantors, have engaged in no economic outlay, and have suffered no cost" (Pet. App. 7). The court of appeals also declined to recast the bank loan to the corporation as a loan to the shareholders, followed by their contribution of the loan proceeds to the corporation. It ex-

plained that "taxpayers are liable for the tax consequences of the transaction they actually execute and may not reap the benefit of recasting the transaction into another one substantially different in economic effect that they might have made" (*id.* at 9). The court of appeals found no error in the Tax Court's determination that the substance of the transaction matched its form of a loan from the bank to VAFLA, not to the shareholders (*id.* at 10-11). The court specifically rejected petitioners' contention that the application of "debt-equity principles" requires treating the shareholder guarantees as if they constituted actual contributions to capital. The court explained that debt-equity principles become relevant only at the second stage of a two-part inquiry; they assist in classifying actual shareholder advances as either debt or equity, but furnish no basis for determining whether there has been an actual outlay in the first place. Here, where the Tax Court correctly found that the loan was made directly from the bank to the corporation, there is no occasion to examine the various debt-equity factors. *Id.* at 8-14.

The court proceeded to explain that, although it rejected petitioners' reliance on *Selfe*, it did not view that case as compelling a different result here (Pet. App. 14-20), and therefore it did not "reject the case completely" (*id.* at 16 n.15). The court stated that it did not disagree with the result in *Selfe*, which simply vacated the entry of summary judgment and remanded for further factual development, "to the extent that the *Selfe* court remanded because material facts existed by which the taxpayer could show that the bank actually lent the money to [the shareholder] rather than to the corporation" (*id.* at 19). The court also stated that, "[t]o the degree that the *Selfe* court agreed with *Brown* [v. *Commissioner*, 706 F.2d 755 (6th Cir. 1983)] that an economic outlay is required before a shareholder may increase her basis in a subchapter S corporation, *Selfe* does not con-

tradict current law or our resolution of the case before us" (Pet. App. 19). The court of appeals did reject, however, "the *Selfe* court's suggestion that debt-equity principles must be applied to resolve the question of whether the bank actually lent the money to the taxpayer/shareholder or the corporation" (*id.* at 19-20).

ARGUMENT

The court of appeals correctly rejected petitioners' argument that Daniel Leavitt's and other shareholders' guarantee of a bank loan to their Subchapter S corporation increased their respective bases in the corporation's stock, thereby relaxing the limitation on their ability to offset the corporation's losses against their individual income from other sources. Moreover, this decision does not create a direct conflict in the circuits that warrants this Court's intervention. Accordingly, there is no reason for review by this Court.

1. Section 1374(c)(2) places a specific limitation on the ability of shareholders to offset the losses of their Subchapter S corporation against their income from other sources — keyed to the amount of their bases in their shares and any amounts that they have lent to the corporation. In the words of the Senate Report, Section 1374 limits the amount of the Subchapter S shareholders' deduction of the corporation's net operating losses "to the adjusted basis of the shareholder's investment in the corporation." S. Rep. No. 1983, 85th Cong., 2d Sess. 220 (1958). The obvious intent of the limitation is to prevent individuals from using Subchapter S corporations as "tax shelters," *i.e.*, from using corporate losses that exceed their investment in the corporation to shelter from tax their income from other sources.

As the courts below held, Section 1374(c)(2) operates to implement this purpose by limiting a shareholder's deduction of corporate losses to the amount of his actual economic

outlay, thereby precluding deductions that exceed the amount of the economic loss suffered by the shareholder. Accordingly, the courts have repeatedly rejected the contention of Subchapter S shareholders that their personal guarantees of loans to their corporations operate to relax the Section 1374(c)(2) limitation by increasing their bases in the corporation's stock. See, *e.g.*, *Brown* v. *Commissioner*, 706 F.2d 755, 756 (6th Cir. 1983); *Underwood* v. *Commissioner*, 535 F.2d 309, 312 (5th Cir. 1976); *Frankel* v. *Commissioner*, 61 T.C. 343, 347 (1973), aff'd, 506 F.2d 1051 (3d Cir. 1974) (Table); *Perry* v. *Commissioner*, 47 T.C. 159, 163 (1966), aff'd, 392 F.2d 458 (8th Cir. 1968);[4] but see *Selfe* v. *United States*, *supra*. Only when a shareholder-guarantor actually is called upon to pay the debt he has guaranteed for the corporation does a loan guarantee yield an economic outlay that increases his basis in the corporation's stock. See I.R.C. § 1012; Treas. Reg. § 1.1012-1(a). In the words of the Sixth Circuit (*Brown* v. *Commissioner*, 706 F.2d at 757), "guaranteeing shareholders must make actual disbursements on the corporate indebtedness before they can augment their bases for the purpose of deducting net operating losses under § 1374." As that court explained (*id.* at 756), "[a]bsent such an outlay requirement, Subchapter S shareholders could readily skirt the limitation embodied in § 1374(c) * * * and thereby erect a tax shelter that Congress undoubtedly never intended to create."[5]

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[4] See also *Harrington* v. *United States*, 605 F. Supp. 53, 56 (D. Del. 1985); *Wheat* v. *United States*, 353 F. Supp. 720, 723 (S.D. Tex. 1973); *Neal* v. *United States*, 313 F. Supp. 393, 396 (C.D. Cal. 1970); *Borg* v. *Commissioner*, 50 T.C. 257, 264 (1968); *Raynor* v. *Commissioner*, 50 T.C. 762, 770-771 (1968).

[5] For example, in this case Daniel Leavitt invested only $10,000 in the corporation but he claimed loss deductions in excess of $13,000, even though he was not called upon during the year at issue to make

The courts below correctly rejected petitioners' contention that an economic outlay from the shareholders to the corporation should be imputed here by recasting the loan as one made directly to the shareholders, followed by their contribution of the loan proceeds to the corporation. It was the shareholders who determined how to structure the loan transaction, and their tax treatment should be governed by the transaction that actually occurred, not by one that they might have entered into. In the words of this Court, they "must accept the tax consequences of [their] choice, whether contemplated or not, * * * and may not enjoy the benefit of some other route [they] might have chosen to follow but did not." *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974); see also *Don E. Williams Co.* v. *Commissioner*, 429 U.S. 569, 579 (1977).

Moreover, there is no basis for rejecting the finding of both courts below (see Pet. App. 10-11, 33) that the substance of the loan in this case was fully consistent with its form as a bank loan directly to the corporation. The loan proceeds were earmarked for use in the corporation's business and were not placed at the shareholders' disposal. Although the bank loan was shown on the corporation's books and tax returns as a loan from shareholders, the corporation made all payments of interest and principal with respect to the loans. Moreover, neither the shareholders nor the corporation treated these corporate payments as constructive income taxable to the shareholders, as would have been appropriate if the loan in fact were from the bank to the shareholders. See Pet. App. 19 n.19. Thus, the courts below correctly held that petitioners made no economic outlay to the corporation in the loan guarantee that would entitle them under Section 1374(c)(2) to deduct a loss

any payment with respect to his guarantee and, indeed, his estate may never be required to do so.

greater than the $10,000 that Daniel Leavitt actually invested in the corporation.[6]

2. a. The court of appeals and the Tax Court correctly rejected petitioners' argument (Pet. 13-14) that the question whether a loan guarantee can increase the Section 1374(c)(2) limitation should be resolved by resort to the principles that are generally invoked to distinguish between debt and equity. This basic debt-equity analysis is applied by the courts to determine the character of funds actually advanced by a shareholder to a corporation. When the corporation is not being taxed under the special provisions of Subchapter S (*i.e.*, a Subchapter C corporation), whether a shareholder advance is classified as debt or equity has significant tax ramifications.[7] But the issue in this case turns on the *amount*

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[6] Petitioners briefly suggest that their proposed approach of allowing shareholder loan guarantees to raise the Section 1374(c)(2) cap should be adopted because it is good policy; they argue that guaranteed amounts are placed "at risk" and therefore should increase the shareholders' basis (Pet. 9) and that this approach would treat Subchapter S shareholders equitably as compared to limited partners in a partnership (Pet. 20). Whatever the merit of petitioners' policy arguments—and one commentator has taken the position that *the statute should be amended* so that loan guarantees relax the Section 1374 limitation (see I. Grant & W. Christian, *Subchapter S Taxation* § 19.7 (2d ed. 1980))—it is apparent that these arguments are properly addressed to Congress, not the courts. Petitioners' " 'hope' " that this result can be achieved " 'judicially rather than legislatively' " (see Pet. 20, quoting 8 ABA Sec. of Taxation Newsletter, *Tax Commentaries* 71 (Summer 1989)) is not consistent with the role of the courts in our system of government.

[7] For example, if a purported loan from a shareholder to his corporation is determined not to be debt, but instead to be a capital contribution, then interest deductions claimed by the corporation for payments to the shareholders would be treated as nondeductible dividends. Similarly, from the shareholder's perspective, amounts denominated as (nontaxable) repayments of the indebtedness would be treated as dividend distributions, which produce taxable income. See,

of petitioners' advances to the corporation, not the *character* of those advances. As the court of appeals noted (Pet. App. 13 n.12), it is irrelevant in the Section 1374 context whether a shareholder advance is classified as debt or equity, since the statute allows both debt and equity investments by the shareholder to increase the limitation on deductible losses. Thus, debt-equity principles are relevant only to what the court of appeals correctly characterized as the second stage of a two-part inquiry (see *id.* at 13-14)—whether a shareholder advance should be treated as debt or equity—that is not germane to the tax controversy in this case. Those principles shed no light on the threshold issue, which is the one that is controlling here—whether the shareholder has made any form of actual investment in the corporation.

b. Petitioners are correct in stating that the court of appeals' refusal to apply the debt-equity factors in this context is at odds with much of the Eleventh Circuit's reasoning in *Selfe* v. *United States*, *supra*. As the court below stated (Pet. App. 19-20), that opinion suggests that "debt-equity principles must be applied to resolve the question of whether the bank actually lent the money to the taxpayer/shareholder or the corporation"—an approach that is inconsistent with the analysis of the decision below. But this disagreement does not warrant review by this Court.

The Eleventh Circuit's decision in *Selfe* does not irreconcilably conflict with the decision below. First, as the court of appeals explained (Pet. App. 19), the court in *Selfe* held only that the grant of summary judgment should be vacated and the case remanded for a factual inquiry into whether the loan was actually made to the shareholder, rather than to the corporation. Here, by contrast, the Tax Court found that the loan was actually made to the corporation. For that

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e.g., *Estate of Mixon* v. *United States*, 464 F.2d 394 (5th Cir. 1972); *Fin Hay Realty Co.* v. *United States*, 398 F.2d 694 (3d Cir. 1968).

reason, the court below did not view its decision as irreconcilable with *Selfe* (see *id.* at 16 n.15). Second, as Judge Williams noted in his concurring opinion in the Tax Court (*id.* at 42-43), *Selfe* is factually distinguishable from the instant case because it involved a sole shareholder (and therefore there was considerably less practical difference than here between a loan to the corporation and a loan to the shareholders), whereas this case involved a loan guaranteed by some, but not all, of the multiple shareholders of the corporation. And finally, the statements of the Eleventh Circuit in *Selfe* stand alone in invoking debt-equity principles to determine the amount of the Section 1374 limitation on the loss deductions available to Subchapter S shareholders; no court has followed *Selfe* in this regard. See generally I. Grant & W. Christian, *Subchapter S Taxation* § 19.2 (Supp. 1989). Thus, there is no assurance that the Eleventh Circuit would have reached a result in this case different from that reached below.[8]

c. As the court of appeals explained (Pet. App. 12 n.11), the other cases relied upon by petitioners (see Pet. 9-10, 16) plainly do not conflict with the decision below. Both *Casco Bank & Trust Co.* v. *United States*, 544 F.2d 528 (1st Cir. 1976), cert. denied, 430 U.S. 907 (1977), and *Lane* v. *United States* (*In re Lane*), 742 F.2d 1311 (11th Cir. 1984), involved the classification as debt or equity of actual shareholder advances to Subchapter C corporations. Thus, these cases were not concerned with the fundamental question here—whether Daniel Leavitt made any kind of actual advance to his corporation in excess of $10,000. Similarly, both *Plantation Patterns, Inc.* v. *Commissioner*, 462 F.2d 712 (5th Cir.), cert. denied, 409 U.S. 1076 (1972), and *Murphy Logging*

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[8] Indeed, even the court of appeals in *Selfe* stated that an "economic outlay is required before a stockholder in a Subchapter S corporation may increase her basis" (778 F.2d at 772).

Co. v. *United States*, 378 F.2d 222 (9th Cir. 1967), involved guaranteed bank loans nominally made to Subchapter C corporations, and the issue was the factual one of whether the loan had in fact been made to the shareholder. In *Plantation Patterns*, the court concluded that the loan, in substance, had been made to the shareholder, and therefore he was charged with a constructive dividend when the corporation repaid the loan. In *Murphy Logging*, the court reached the opposite conclusion and refused to charge shareholders with constructive dividends. Neither case involved the limitations imposed by Section 1374(c)(2), and they have no bearing here where the Tax Court found that the substance of the loan matched its form, *i.e.*, that the loan in actuality was made to the corporation and hence did not represent any economic outlay on the part of the shareholders.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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